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INDUSTRY REPORT

RETAIL IN INDIA: METAMORPHOSIS OF THE SHOP NEXT DOOR

ONICRA
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ONICRA CREDIT RATING AGENCY OF INDIA

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EXECUTIVE SUMMARY

The retail industry in India has witnessed tremendous growth driven by favorable government policies, growing urbanization, changing lifestyle, increasing per capita income and a higher propensity to spend. The market size has increased by approx. 10.66% between the period 2010 to 2012. The retail industry contributes approx. 15% of the GDP.

Consolidation amongst the retail players, foreign players entering the Indian retail space, mergers and takeovers have increased the competitiveness of the market. With increased competition, it is the consumer who stands to gain. SMEs shall be playing a key role in delivering the retail product to these new players on the back of the policy initiative by the Government. While the proliferation of supermarkets and hypermarkets have helped to develop better supply chain efficiencies, the increased competition resulting from the plethora of choices makes the purchase of the products more lucrative for the customers also. The industry is rapidly moving from a predominantly unorganized market to more organized retailing.

Online Retailing holds a lot of promise for the future of retail in India. Largely unexplored till now, the online retail is propelled by factors such as shooting real estate prices, secured online financial transactions, increasing financial inclusion and limited personal time at the disposal of today's consumer. Rural India too has been swept by penetrative retailing, paving way for an inclusive growth in retail.

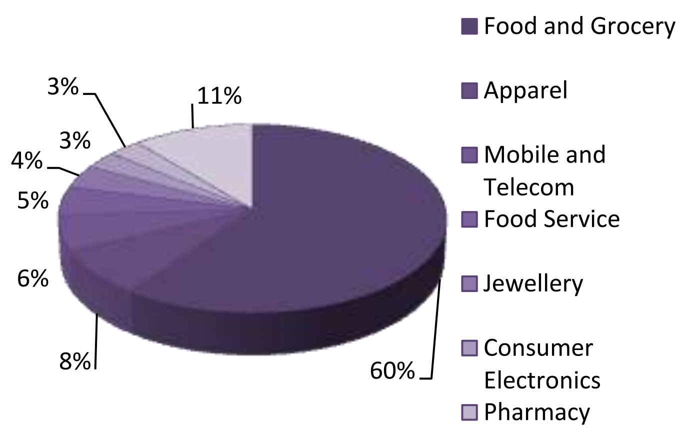
With government allowing 51% Foreign Direct Investment (FDI) in multi brand retail and 100% FDI in single brand retail, the inflow of investment in the retail segment has got the required shot in the arms. The notification of the new policy has the potential to boost the Indian GDP and the economic growth.

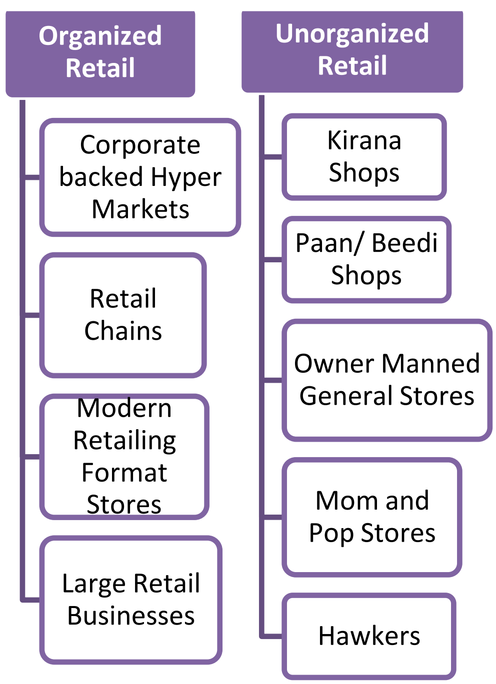
INTRODUCTION

The retail industry in India accounts for approx. 15% of the GDP and has a total market size of around USD 518 billion (bn) in 2012. As per the sector report of Federation of Indian Chambers of Commerce and Industry, the retail sector is expected to grow to a total market size of USD 850 bn by 2020.

The catalyst for this growth shall be the 'food and grocery' segment, followed by apparel and mobile and telecom segment.

Segmental Share of Revenue of Total Retail Market





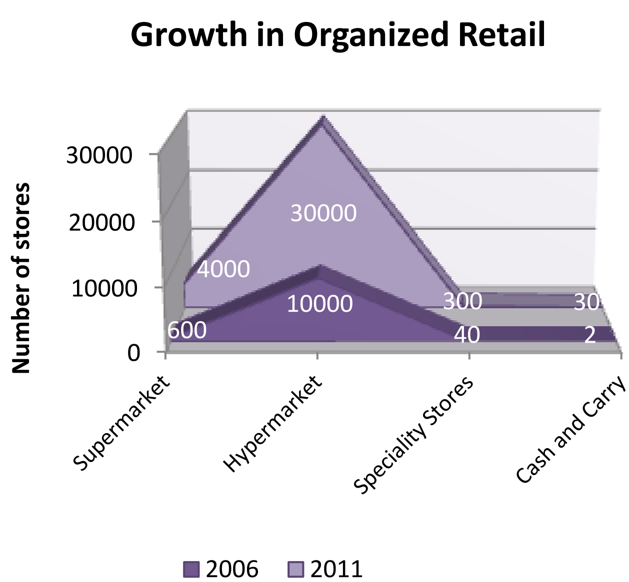
Most of the retail in India is through the unorganized sector, which holds approx. 92% of the total retail market. The share of organized retail market is very low (only 8%) in India, as against some of the other countries where it holds approx. 85% share of the total retail market. One of the reasons for stronghold of unorganized market is its penetration. The organized sector has lacked the finances to penetrate into the towns and districts of the country. With the allowance of FDI in multi brand retail and increased FDI in single brand retail, the scenario is expected to change.

EMERGING TRENDS IN INDIAN RETAIL

Retailing as a business was conceptualized as long back as the civilizations were being developed. However, it is only since early 21st century that the importance of retailing is being felt. Corporate are deliberately investing in various forms of retail such as organized retail, online retail, advertising and enhancing the penetration of their brands to lower than tier-II cities etc. This has led to increase in the competition levels among the retail players, emergence of bigger players by way of global entries in India, consolidation of Indian players with global players, increase in retail space and shift towards organized retail. All these changes have greatly influenced the evolution of the Indian retail industry.

a. SHIFT TOWARDS ORGANIZED RETAIL

With the changes in the demographics of the Indian consumers, the organized retail market is expected to increase its share to 20% by 2020 from 8% currently. There has been a significant growth in the organized retail outlets in the recent years. The growth of organized retail is expected on the back of the growth across the various organized retail formats and across retail segments.



b. E-COMMERCE AND WEB BASED RETAIL (INCLUDING MOBILE RETAIL)

E-commerce has been touted by experts as the biggest innovation in the retail industry. It is projected to increase from a market size of USD 70 bn in 2011 to USD 200 bn by 2020. With growth in e-commerce, online retail is expected to grow from USD 0.60 bn in 2011 to USD 7 bn by 2020. This has been a result of:

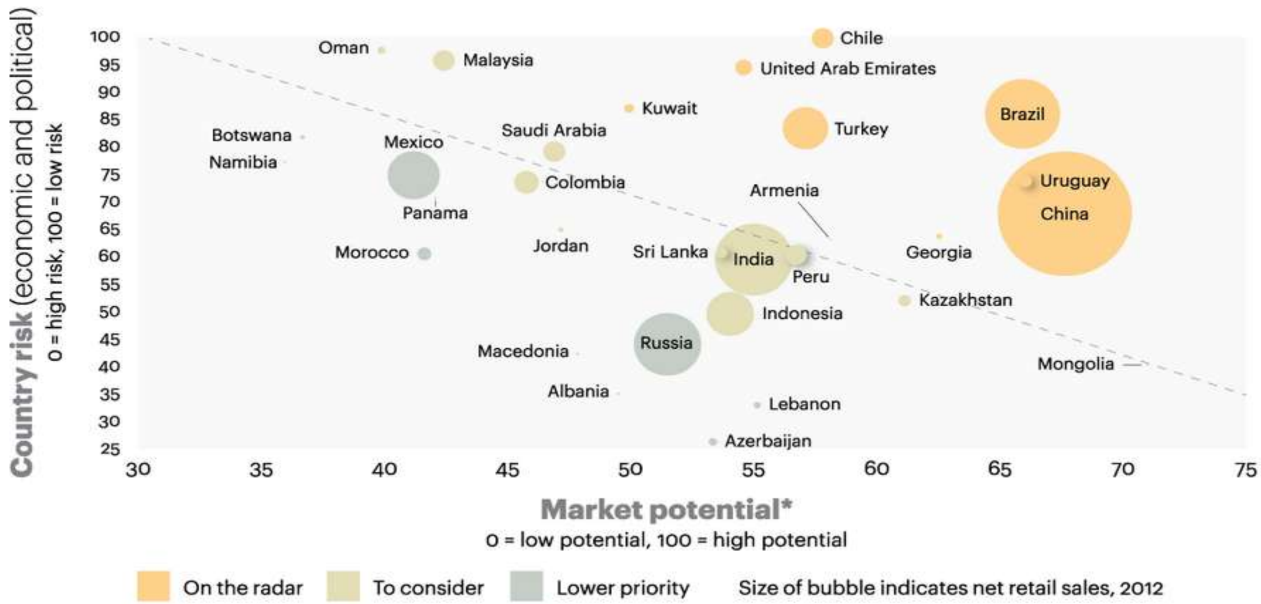
- Increase in the urban population and more subscribers for internet network
- Emergence of new techniques such as mobile applications, cloud-computing based applications
- Easy online money transfer/ payments facilities being offered by banks, which are going online/ mobile
- Increase in working population which does not have time to physically visit stores

Online retailing has become more competitive than ever before. Retailers are displaying the products with detailed specifications and discounted prices including freebies and offers online. Now-a-days, there are easier ways to make comparison between similar products of different brands online relative to physically visiting the retail store. Facilities offered like cash on delivery has created new business opportunities in e-retailing.

As per a survey by Associated Chambers of Commerce and Industry (Assocham), the online retail web sites have witnessed a 65% rise in traffic in 2012 since 2011.

c. EMERGENCE OF INDIAN RETAIL ON WORLD MAP

India holds the 14th rank on the AT Kearney's Global Retail Development Index 2013 (To be considered for fresh investment level) and has been ranked 6th and 1st on the index in 2012 and 2009 respectively. The decline in the rank is attributed to the slow economic growth in the last few years. However, the long term fundamentals still remain strong and retail is expected to grow at 14-15% in 2014-15. With an approx. 60% of population falling under the young and income earning bracket, a greater brand and fashion consciousness, increasing working population, more working females, and increasing urbanization auger a good growth potential for the future of retail.



* Based on weighted score of market attractiveness, market saturation, and time pressure of top 30 countries

Source: Planet Retail, Economist Intelligence Unit, A.T. Kearney Analysis

d. INFLOW OF FOREIGN INVESTMENT IN INDIAN RETAIL

In September 2012, the Indian government opened the gates of fresh investment into the retail Industry by allowing 51% FDI in multi brand retail and 100% investment in single brand retail. Consequently, there has been a flurry of global brands queuing up for entry into Indian markets. Several single branded retailers entered India in many sectors such as apparels (Brooks Brothers, Kenneth Cole, Armani Junior), boutique (Roberto Cavalli, Christian Louboutin) and food & beverages(Starbucks, Dunkin Donuts) etc.

The FDI in single brand retail trade during the period April 2000 to September 2013 stood at USD 0.10 bn, as per the data released by Department of Industrial Policy and Promotion. On the other hand, in September 2012, the FDI inflow since April 2000 was only USD 0.04 bn. The share of FDI inflow in single brand retail to total FDI inflow has increased from 0.02% to 0.05% over the year.

Some of the news headlines for the months of Nov-Dec'13:

- Celebrity Fitness Guru Kris Gethin to open gyms across India
- Carrefour opens wholesale cash and carry store in Bangalore
- Tangerine Home Couture launched in India
- Swedish retail giant H&M gets govt. nod to invest ₹ 720 cr in India
- Furniture brands brace up for Ikea's impending entry into the Indian market
- Pals Plush has set up its unit in Andhra Pradesh with an investment of USD1.5 million
- Furniture Republic, Franchise India tie-up: to set up 100 stores in next 5 years
- Swarovski seeks nod for 100% owned single-brand retail arm in India
- Reliance Retail inks pact with US retailer Payless ShoeSource
- US President shoe maker enters India with Mumbai store

e. CONSOLIDATION OF RETAIL PLAYERS IN INDIA

Given the stiff competition being faced by retailers with the entry of global brands and increasing awareness among the consumers, the retailers have to make significant investments in the retail space, infrastructure, personnel and its operational activities. To raise more finance for the same and as a result of the inflow of investment, there have been significant changes in the shareholders and management of the retail companies.

Acquirer Name	Target Name	Year	Deal Type
Future Venture India Ltd.	Big Apple (Convenience Store)	September 2012	Acquisition
Peter England Ltd.	Pantaloons Retail India Ltd	September 2012	Acquisition
Pantaloons Retail India Ltd.	R&R Salons	May 2012	Private Equity
Phoenix Mills Ltd	Classic Housing Projects P Ltd	March 2012	Acquisition
Flipkart Online Services Pvt. Ltd.	E tree Marketing Pvt. Ltd.	February 2012	Acquisition
Gitanjali Gems Ltd	Crown Aim, China	December 2011	Acquisition

The above data is only a sample of the mergers and acquisitions in the Indian retail industry. A few more are under process and more changes in the management of the retailers are expected shortly.

f. STRATEGIC RETAIL

Retail stores are opting for innovative techniques to make the retail business more competitive and lucrative for the consumers. Some of the examples of their offerings are membership discounts, happy hours, partnering with manufacturers, special product packages for niche customers such as students, house-wives, senior citizens etc. It has been noted that competing with the highly localized stores may be difficult for a big organized retail store. To be more competitive than the mom and pop stores, organized players are constantly improving the supply chain and logistics. Retail stores such as Reliance Retail are doubling up as cash and carry model along with their role of being a hyper market. Idea behind is to convert the mom and pop stores into their customers.

In fact, different retail stores are carving out their own unique strategies in the present competition. For example, Future Retail is trying to carve a space for itself in multiple retail format while the Shoppers Stop is striving to be a leader in the diversified market strategy.

g. INCREASED RETAIL SPACE

Increased participation by the private and foreign players has given a boost to the retail infrastructure. Modern Retail stores are expected to reach a number of 67,100 by 2016 from 11,192 in 2006. The display of the products has increased and more number of products is being housed under one roof. Customers have more choice as many brands are on display. This also triggers impulsive purchasing.

The retail space assumes its importance from the viability of the location, which would result in increased footfalls and minimum vacancy levels at the mall. Even though the real estate prices have increased exponentially in the recent past, it has not deterred the mushrooming of malls all across India.

h. RURAL RETAILING

Big players in the retail industry have identified the opportunity in rural retail and understood that the need of rural retail is different from that of urban retail. They have created separate models to target the niche rural market. HUL's Shakti or M&M's Shubhlabh reach out to meet the specific needs of rural India. ITC's E-choupal and Choupal Sagar, Godrej Agrovet's Aadhar and Tata's (Tata Kisan Sansar) have enabled the rural producers to exhibit more confidence in them-selves. The rural buyers are more aware, enabled and confident today. National Sample Survey Organization data shows that in 2011-12, for the first time, more than 50% of enhanced rural spend was on non-food items.

DEMAND DRIVERS

a. CHANGING DEMOGRAPHICS AND RISING INCOME LEVELS

India has approx. 48% of the population in the age group of less than 21 years, which is the growth age group. 45% of the Indian population falls within the age bracket of 15-45 years. This age bracket has a higher disposable income in its hands and a higher propensity to consume quality branded products. Increasing nuclear families, working women, and limited personal time have altered the buying behavior of the consumers. There has been an expansion in the middle class and the upper middle class, which has led to a greater spending on luxury products and high brand consciousness. Changing preferences of the consumers has shifted the focus from value retailing to luxury retailing.

With the globalization and urbanization of the Indian economy, the levels of awareness and consumerism have increased. The robust consumption from the tier-II cities and rural India has enhanced the prospects of the retail industry in the long-term future growth. Rural India too has become more conscious of their personal grooming and aspires as their urban peers. Government schemes under National Rural Employment Guarantee Act

(NREGA) have raised the disposable income of rural India, which has in turn driven up the retail demand.

b. IMPROVED EXPERIENCE AT THE SALES POINT

With better infrastructure being created by the increasing investments by bigger players and the foreign investors, and the leverage of increased retail space, retail stores have garnered increased footfalls. Coupled with investments in their front end sales and the variety of products being offered, buyers can enjoy a better and more guided purchase program. E.g. Big Bazaar offers a package of products at a specified rate. The package comprises of monthly ration of a standard household. This makes the purchase decision of the consumers easier and can trigger additional purchase of some extra product.

c. EASY ACCESS TO RETAIL

With innumerable options such as mobile retailing, web based retailing, the distance between the buyer and the market has closed down. The pain of going to the physical market place has been removed. Recently, a trend has been noted that consumers are making a lot of buying decisions, even for a product of high value, such as a home, over the internet. This provides 24*7 access to retail, saves time and ensures secure transaction.

d. EASY FINANCING OPTION

The retailers are consorting with banks and Non Banking Financial Corporations to offer easy finance to the buyers, especially for the durable products including homes. Plastic money, easy installments, redeemable loyalty award points, higher discounts during happy hours are some of the financing innovations that have made the purchase for the consumers easier, thereby pushing forward the growth of the retail.

REGULATORY ENVIRONMENT

Government has played a key regulatory role in the retail sector in India. Foreign Direct Investment was allowed in retail in 1997 for the first time in India, but was limited to cash and carry model only and that too with government approval. Over the period, the norms were relaxed, however, the required impetus needed from the government to further boost the industry was provided in September 2012 when FDI norms were liberalized. The salient features in the new FDI policy are:

51% FDI in multi brand retail:

- Minimum investment by foreign investor is USD 100 mn
- Approval of state government for the opening of the retail store
- Multi brand retail store to open only in cities with a population of 100 mn as per 2011 census or approved by the state government
- 30% procurement of manufactured or processed products must be from SMEs.
- Government reserves the first right to purchase agricultural produce rather than the retail store
- Minimum 50% of total FDI must be invested in back-end infrastructure (logistics, cold storage, soil testing labs, seed farming and agro-processing units) within first 3 years

100% FDI in single brand retail:

- Products to be sold under the same single brand internationally
- Sale of multi branded goods is not allowed, even if produced by the same manufacturer
- For FDI above 51%, 30% of the sourcing must be from SMEs, wherever possible
- Any additional product category to be sold under the single brand retail must first receive additional government approval

Though the policy change was welcomed by the markets, there was resistance from some sections within the economy on grounds of the middlemen being eliminated. This would entail loss of jobs, entrepreneurs and may also impact the buying behavior of the consumers. The government has tried to build some features within the policy so that the concerns raised can be addressed. Minimum procurement of 30% from SMEs is aimed at promoting the small entrepreneurs. Government has also reserved with itself the first right over agricultural produce to control prices. However, the full impact of the policy initiative by the government is yet to be ascertained.

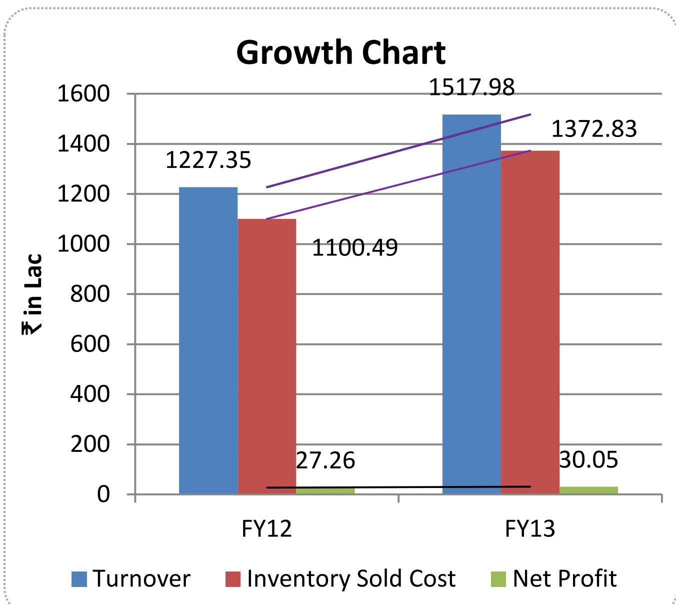
ONICRA'S OUTLOOK ON SMEs IN INDIA

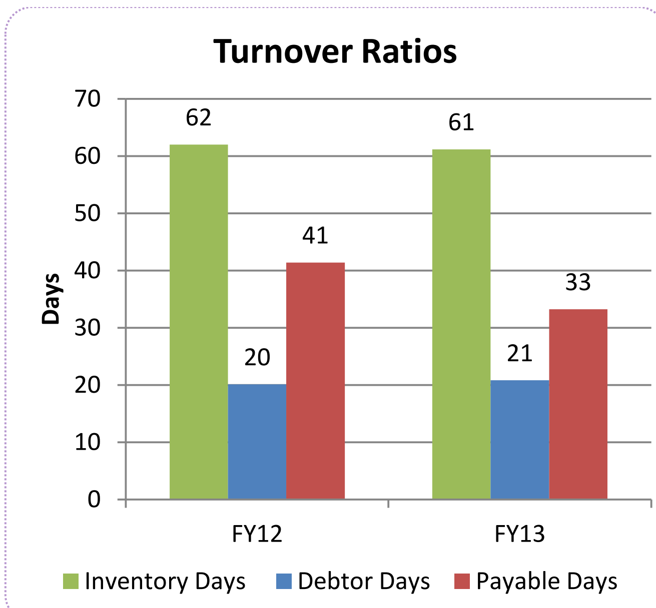
The retail industry is highly unorganized in India. It is characterized by mom and pop stores, kirana stores, hawkers that meet the daily needs of the households in India. The industry has encouraged small entrepreneurs all across India and facilitated the consumers with door step delivery. SMEs in the retail industry form a part of such enterprises.

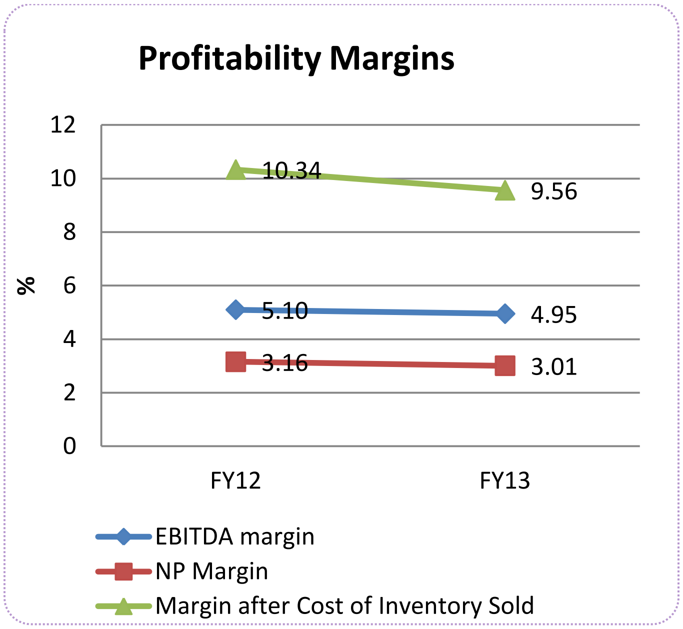
A financial analysis of SME units engaged in retailing business was undertaken to understand the dynamics of the SMEs in retail. A sample set of 30 units was chosen from the entities that have been rated by Onicra over the period September 2013 to December 2013. These entities are engaged in retailing of a variety of products such as agricultural produce, consumer durables, fast moving consumer goods, household and personal products, medicines, apparels etc.

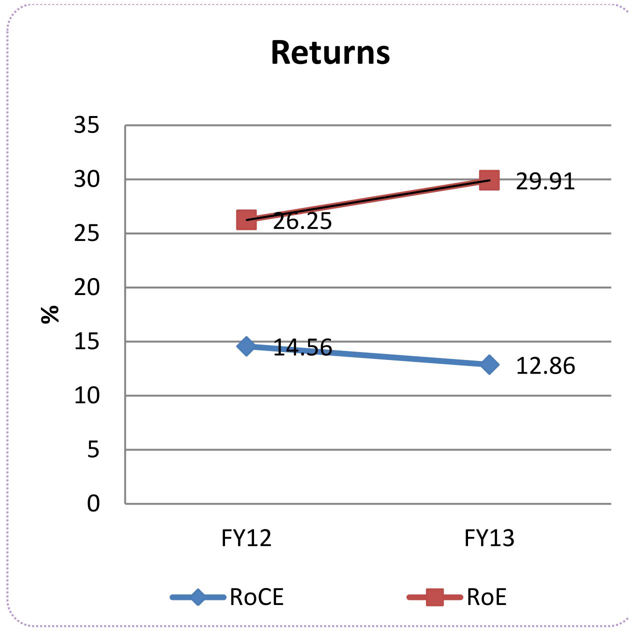
The results of the financial analysis have been detailed below.

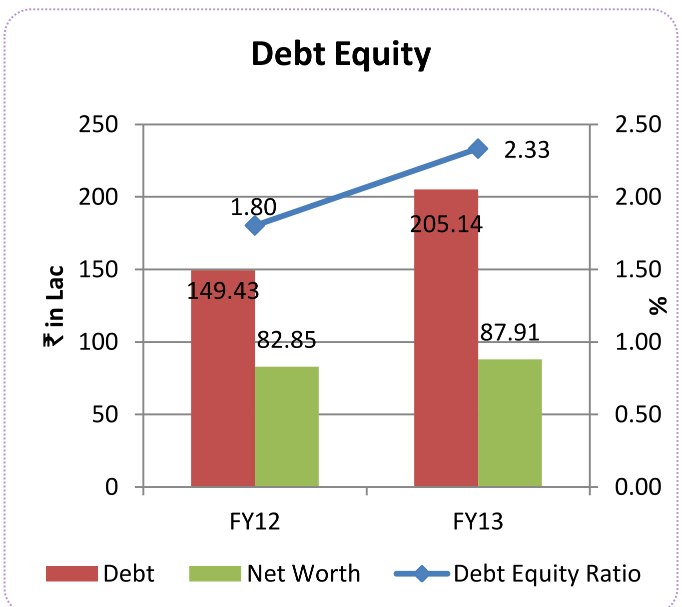
FINANCIAL ANALYSIS

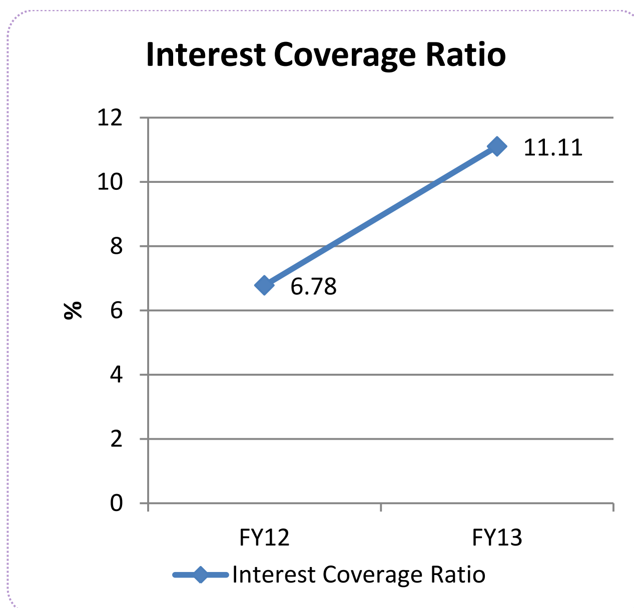





Profitability Margins
%
12
10
8
6
4
2
0
10.34
9.56
5.10
4.95
3.16
3.01
FY12
FY13
EBITDA margin
NP Margin
Margin after Cost of Inventory Sold


Returns
%
35
30
25
20
15
10
5
0
29.91
26.25
14.56
12.86
FY12
FY13
RoCE
RoE


Debt Equity
₹ in Lac
250
200
150
100
50
0
2.50
2.00
1.50
1.00
0.50
0.00
%
2.33
1.80
205.14
149.43
82.85
87.91
FY12
FY13
Debt
Net Worth
Debt Equity Ratio


Interest Coverage Ratio
%
12
10
8
6
4
2
0
11.11
6.78
FY12
FY13
Interest Coverage Ratio

Revenue growth remained strong however tough competition forced the margins to remain constrained: The turnover of the SMES in retailing increased by 23.68% in FY13 re-iterating the growth rate of the retail in the Indian economy. The most important cost component in retail is the cost of inventory sold (Purchase + Opening stock – Closing Stock), which constituted 89.66% and 90.43% of sales in FY12 and FY13. This is indicated by the ratio 'Margin after cost of Inventory Sold', which stood at 10.34% and 9.57% in FY12 and FY13 respectively. The inventory sold cost has also increased by 24.75% in FY13. The high inventory sold costs have left little margins to the SMEs to engage in providing any value added services.

As the industry becomes more competitive, it becomes difficult for the SMEs to pass on the rise in expenses to the consumers. Consequently, the EBITDA margin and the Net Profit margin have decreased by 2.94% and 4.65% in FY13 respectively.

The return on equity has increased while the return on capital employed of the sample has decreased. Although the net profit of the SMEs has increased by 10.24% in FY13, the promoters have been wary of investing more capital in their retail ventures. The average net worth of the sample has increased by only 6.11%, leading to an increase in the return on equity.

The exposure to debt of the SME units rated by Onicra is more than double of equity invested in the business in FY13. The debt of the SME units has increased by 37.28% in FY13 against the 6.11% increase in the net worth in FY13. It was observed that most of the debt funding in FY13 was made in the form of unsecured long-term debts. The unsecured loans were largely interest free loans from related parties, which has resulted in a better interest coverage ratio.

The working capital cycle of the SME units has been satisfactory. The retail industry is working capital intensive. A variety of inventory is held for display to meet the customer expectations. In the present competitive environment, retailers have to offer easy financing option to the customers which also requires working capital. The inventory (holding) days and the debtor (collection)days for the sample were 61 days and 21 days respectively in FY13. Part of this requirement was met through 33 payable (Creditor payment) days. On the whole, the cash cycle (Inventory Days + Debtor Days – Creditor Days) was around 49 Days in FY13, indicating a good cash turnround.

CHALLENGES THAT ONICRA FORESEES FOR SMEs IN RETAIL INDUSTRY

The retail in India suffers from a number of supply chain inefficiencies. Being driven by smaller players, the capacity of the SMEs to store large quantities and leverage on logistics is not possible. The producer has to go through a number of middlemen and states, to sell their products in a particular market. Before the sale is made, he may have to suffer leakages owing to theft, shoplifting, perishibility of the product, pilferage etc. The regulatory and taxation problems add to the producers' woe.

In a bid to liberalize the retail market, the Government has allowed greater FDI in retail. The policy was criticized on various grounds that it would eliminate middlemen and has the potential of harming small entrepreneurs. With big retail stores housing most of the products at one place and allowing more access to shelf storage, the consumers will shun the small kirana shops. Big retail stores would better manage their supply chain, thereby decreasing logistics cost and offering products at more competitive prices. It was also argued that though this may benefit the consumer and decrease inflation, losses to the economy due to unemployment may be higher. This would be a result of retail-based SMEs shutting shop. Keeping this in view, the government has, in its new FDI policy on retail, guided the foreign investors to procure minimum 30% of the products to be retailed from SMEs. However, it has been researched that most of the home grown big retailers are sourcing not more than 25% from the SMEs. Moreover, the government has asked the foreign investors to invest minimum 50% of the FDI in back end infratsructure such as logistics, cold storage. This too will have a cascading effect on the existing SMEs in the industry and the benefits of a better infrastruture will accrue to them also. While the government is trying to play its part in protecting the interests of the SMEs, the small enterprises too have to tighten their belt in the wake of increasing competition. Recently, there was a wave in SMEs to start using barcodes to avoid leakages of retail products at their end. These are small small changes that the SMEs need to bring in their operations to adjust to a policy change, of which the results are still not clear to ascertain how conducive the policy will be towards SMEs.

Apart form the above, the SMEs due to their inherent nature, suffer from a multitude of limitations. Some of the specific issues being faced by SMEs operating in retail industry are listed below.

- SMEs can concentrate only in few cities and towns as they lack the infrastructure & funds for registering themselves at national level.

- Lower scale of operations, inadequate logistics and improper supply chain management has created huge problems for the smaller players. Such inefficiencies lead to escalation of the cost of product and impact the profitability of the SMEs.
- The access to finance for future growth has been a major issue impacting SMEs. Retail industry does not require much of fixed assets but its working capital requirements are quite high. Funds are required to hold the inventory levels to offer variety to the consumers and to offer the desired credit period to the buyers.
- With new technologies coming up, the SMEs face the challenge to scale up to the new levels or risk the threat of elimination. With changing lifestyles and buying behavior, online retailing is catching up. Cloud computing, mobile applications, web based sales are exposing the SMEs to newer market spaces.

OUTLOOK

Economic slowdown has hampered the growth in the retail industry. Consumers are contracting their spend on account of increase in job losses, volatility in stock markets and increased chances of prolonged recession. Organized retailers are finding it difficult to woo customers away from the unorganized retailers. For organized retail to grow, it is imperative for them to offer more convenience in terms of superior logistics, pricing or location. With the government approving FDI in retail, supply chain inefficiences and inadequate infrastructure can be plugged. This will offer a long-term growth impetus to retailing in India. In the short run too, the retailing in India is expected to grow on the back of the dominant young population. It is expected that the young population in India will constitute 53% of total poulation by 2020 and 46.50% by 2050 – much higher than even the US, the UK, China and Germany.

Retailing in India is a heterogeneous mix and the strategies to be followed vary with the target segment, the format followed and the products offered. The retail trends to be watched are online retailing, luxury retailing and rural retailing. Online retailing is highly cost competitive, can avoid retail shrinkage occurring due to pilferage and thefts, is highly convenient and is not time barred. With an increase in the internet subscriber base, this form of retail will be going places. Luxury retailing is expected to grow at a rate of 25% per annum, and India is expected to be the twelfth largest luxury retail market. Rural retailing is the focus of retailers. Rural market comprises 40% of the total consumption in India. Corporate are devising new strategies to target this market.

India has already carved its place on the world map. Though the economic slowdown has impacted the retail industry also, the improving prospects and a strong fundamental position will drive the retail industry forward.

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